

## The Impact of Board Composition on Accounting Profitability of the Firm

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### **Abstract**

*The issue about corporate governance became more prominent in recent years as a result of corporate scandals and misconduct of executives. Firms, board members, and executives have been subject to criminal and civil actions over hidden debt, inflated earnings, insider trading, tax evasion, misuse of funds, and breaches of fiduciary duties. Firms such as Enron, WorldCom, and Tyco became well-known because of huge failures in governance. In addition to the scandals, nowadays, we can see that the financial crises have brought attention for today's debate of corporate governance issue as well. Board is the major component of corporate governance like chief executive officer (CEO), shareholders, stakeholders or community in general. This board is authorized to decide on the operations, management, and strategy of the company on behalf of the shareholders. Since the board members suppose to represent their interests.*

**Keywords:** Board, Composition, Accounting, Profitability, Firm

### **1. Introduction**

Corporate governance is governing of corporations which focus primarily on the interactions among corporate managers, directors, and shareholders to minimize the potential agency problem of aligning interests of management with those of shareholders. And can broadly be defined as a mechanism which focuses on the combination of applicable laws, regulations, and listing rules that facilitate to direct and monitor corporations' affairs in attracting capital and performing effectively and efficiently to increase shareholders' value (Rezaee and Riley, 2009, p.122). Corporate governance concerns and challenges are rising in modern society because of the increasing size and complexity of firms driving the need for increased separation between ownership and control, and millions of investors have been harmed in recent years by unusual and criminal behavior in large companies mostly in North America and Europe (Picard, 2005, p.v). The issue about corporate governance became more prominent in recent years as a result of corporate scandals and misconduct of executives. Firms, board members, and executives have been subject to criminal and civil actions over hidden debt, inflated earnings, insider trading, tax evasion, misuse of funds, and breaches of fiduciary duties. Firms such as Enron, WorldCom, and Tyco became well-known because of huge failures in governance (Garg, 2007, p.40). In addition to the scandals, nowadays, we can see that the financial crises have brought attention for today's debate of corporate governance issue as well.

Board is the major component of corporate governance like chief executive officer (CEO), shareholders, stakeholders or community in general. This board is authorized to decide on the operations, management, and strategy of the company on behalf of the shareholders. Since, they represent their interests. In other words, it has influence on the future viability and continuity of the company. In addition, it is the guardian of shareholder welfare, as well as charged with the

responsibility of ensuring that top managers are behaving in a way that will optimize firm performance for shareholders (Liu and Fong, 2008, p.2).

National and international regulators argue that the corporate scandals are the results of poor board management and its corporate practices which lead to declining firm's performance. The existence of good corporate governance practices helps to prevent corporate scandals, fraud, and potential civil and criminal liability of the organization. It is also used to make good business. The image of good corporate governance enhances the reputation of the organization and makes it more attractive to customers, investors, suppliers (Lipman, and Lipman, 2006, p.3). Aguilera and Cazorra (2009, p.377) mentioned some universal principles of codes of good governance for effective corporate governance that are common to most countries. They are: a balance of executive and non-executive directors, such as independent non-executive directors; a clear division of responsibilities between the chairman and the chief executive officer; the need for timely and quality information provided to the board; formal and transparent procedures for the appointment of new directors; balanced and understandable financial reporting; and maintenance of a sound system of internal control.

The definition of a good or poor board depends on the nature of the industry they engage. For example, a board of a manufacturing firm probably should include someone who has worked in the same or similar industry for many years and has achieved some success in it. A board that consists of members that have different backgrounds may also be a good board. But generally a good board is a board that has members with relevant experience and expertise (Kim and Nofsinger, 2007, P.46). And as we mentioned above board is the eye of the corporation which overlooks the activities of the CEO (Kim and No singer, 2007, p.41). Therefore our objectives in this paper are to contribute to the international corporate governance research agenda by describing the corporate governance environment for Swedish's Large Caps and to examine the board composition and firm performance in accounting perspective, and the relationship between them, in Swedish context.

## **2. Literature Review**

### *2.1 Definition and Concept of Corporate Governance*

"Corporate governance is a set of relationships between a company's management, its board, its shareholders and other stakeholders. Corporate governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined (Hand, Isaaks, and Sanderson, 2004, p.229)."

Corporate governance deals with the relationships between owner and management, distribution of power and responsibility in corporations (Picard, 2005, p.2). The study of corporate governance is complicated since the structure, role and impact of boards have been studied from a variety of theoretical standpoints, which resulted in a number of competing theories concerning best corporate governance practice. Therefore it is vital for researchers to notify current corporate governance practice (Kiel and Nicholson, 2003, P.190). According to various theories, the aim of corporate governance has been to put a link between various characteristics of the board and corporate performance. As such the corporate governance structure like ownership structure, board composition, board size, debt, and CEO duality have a great influence on performance (Ehikioya, 2009, p.233).

The concept of corporate governance has made boards of organizations popular and critical. Shareholders in a publicly held corporation cannot represent themselves therefore they have to select others to perform that function for them. They have to elect a specified number of qualified and respected people to represent their interests as members of a corporation's board of directors. As a result, together with management boards pursue objectives that are in the interests of the organization and its stakeholders, facilitate effective monitoring and encourage an organization to

use its resources more efficiently (Kiel and Nicholson, 2003, P.190).

Currently there is an emphasis on corporate governance stems mainly from the occasional failure of corporate governance mechanism to adequately monitor and control top level managers' decisions. The situation results in modifying in governance mechanisms in corporations throughout the world, especially with respect to efforts intended to improve the performance of boards of directors (Hitt, Ireland, and Hoskisson, 2009, p.277).

## *2.2 Theoretical Frame Work*

Two theories which explain and are related to the research paper such as agency and stewardship theories were used. Regarding to corporations and issues of corporate control, agency theory views corporate governance mechanisms, especially the board of directors, as an essential monitoring device which minimize any problem that may be brought about by the principal agent relationship (Mallin, 2007, p.12). Stewardship theory argued that trustworthy and cooperative relationships between principals and board of directors are positively correlated with firm's performance (Leong, 2005, p.355). Either agency theory or stewardship theory are validated as one best way to corporate governance considering that all managers are either stewards or agent. Both theories raise two contrasting approaches to the composition of corporate boards (Donaldson and Davis, 1991, p.49&62).

## *2.3 Agency Theory*

These days, more attention is given on directors and executives pursuing their own interests, by investing in expanding their own asset in contrast to increasing the return to their shareholders. Since agency problem has influenced on the structure and composition of boards, it continues to be important in governance terms, on the requirements for disclosure, and on the balance of power between shareholders and directors (Cadbury, 2002, p.4). Agency theory explains the conflict of interests between the shareholders-principal and managers-agent and the separation of ownership and control. This has been one of the most controversial issues in the financial literature (Ehikioya, 2009,p.231).

"An entrepreneur, or a manager, raises funds from investors either to put them to productive use or to cash out his holdings in the firm. The financiers need the manager's specialized human capital to generate returns on their funds. The manager needs the financiers' funds, since he either does not have enough capital of his own to invest or else wants to cash out his holdings. But how can financiers be sure that, once they sink their funds, they get anything but a worthless piece of paper back from the manager (Shleifer and Vishny, 1997, p.740-741)." Bonazzi and Islam (2007, p.7-8) argued that a well-developed market for corporate controls is assumed to be non-existent in agency theory, and leads to market failures, asymmetric information and incomplete contracts. As a result a gap exists between the information the manager and the shareholders have. The principal prevented from perfectly monitoring the agent where there is asymmetric information, and the incomplete contract makes it impossible to determine what will occur in all possible contingency (Black, Hashimzade, and Myles, 2009, p.7). It is being advocated that there are numerous governance mechanisms which include monitoring by financial institutions, prudent market competition, executive compensation, debt, markets for corporate control, and concentrated holdings, developing an effective board of directors. For an optimal corporate governance mechanism, developing an effective board of directors stays an important and feasible alternative among all these mechanisms (Bonazzi and Islam, 2007, p.7-8). Most literature on the theory of the firm and corporate governance suggest that the agency problem that arises with absentee ownership can be reduced by a firm's board of directors (BOD) which is an important institution for mitigating the conflict. The agency problem in this context is that the interests of management may differ from the interests of the shareholders for whom the BOD work (Murphy

and McIntyre, 2007, p.209). In addition, there are several mechanisms which can reduce these agency problems. Among the many are, managerial shareholding that is an obvious one, concentrated shareholdings by institutions or by block holders that can increase managerial monitoring and so improve firm performance, as an outsider representation on corporate boards (Agrawal and Knoeber, 1996, p.377-378). According to Donaldson and Davis (1991, p.49) agency theory argues that shareholder interests require protection by separation of board chair and CEO roles (Donaldson and Davis, 1991, p.49). Where CEO duality is retained, shareholder interests could be protected by providing suitable incentive scheme-the long-term compensation which aligns the interests of the CEO and the shareholders. "Any superiority in shareholder returns observed among dual CEO chairs over independent chairs would be explained away by agency theory as being due to the spurious effects of financial incentives (Donaldson and Davis, 1991, p.51-52)."

#### *2.4 Stewardship Theory*

In contrast with Agency theory, Stewardship theory argued that any observed superiority in shareholder returns from CEO duality was not a spurious effect of greater financial incentives among CEO-chairs than among independent chairs. Regarding with the role of the CEO, they are assisted by the structures to attain superior performance by their corporations to the extent that the CEO exercises complete authority over the corporation and that their role will be unambiguous and unchallenged. As the power and authority are concentrated in one person who means CEO is also chair of the board, there will not be a room for doubt as to who has authority or responsibility over a particular matter. Likewise, corporate leadership will be expected to be clearer and more consistent both for subordinate managers and for other members of the corporate board. The organization has benefits of choosing unity of direction and of strong command and control. According to the proponents of the stewardship theory, they focus not on motivation of the CEO, but rather facilitative, empowering structure. CEO and chair role, CEO duality will assure effectiveness and produce superior return for share holder (Donaldson and Davis, 1991, p.51-52).

It is argued that stewardship theory claims, good stewards of the resources entrusted to managers since they are essentially trustworthy individuals. Additionally, superior corporate performance is linked to a majority of inside directors since they are working to maximize shareholders' long term profit. This is due to the fact that inside directors understand the business they govern better than outside directors and as a result they can make more effective and efficient decision making. Similarly, CEO duality is considered as a positive leading force towards better corporate performance, because there is quite clear company leadership. Underlying this rationale is the assertion that since managers are naturally trustworthy there will be no major agency costs. Proponents of stewardship theory argue that, for fear of putting at risk their reputation, senior executives will not get benefit at the shareholders' expense (Kiel, 2003, p.5). While the opponents argued that, the relationship between the directors and share holder is like it was between agent and principal. Besides an agent will act with self interest and cannot be expected to behave in a manner assumed in the stewardship theory (Wei, 2003, p.14).

#### *2.5 Board of Directors*

"The board of directors is a group of elected individuals whose primary responsibility is to act in the owners' best interests by formally monitoring and controlling the corporation's top-level executives (Hitt et al., 2009, p.285)".

In many countries in Europe, two tier board structures are a legal requirement for large companies. The two-tier system has benefits over the one-tier system since it allows a clearer separation between the supervisory body and the executive being supervised though the one-tier system allows closer relationships and better flow of information between directors and executives

(Clarke, 2007,p.174).

BOD that deals with complex issues under potentially ambiguous task and role situations can be viewed as organizational teams. The contribution of both the characteristics and functionality of a board is likely to be influenced by a number of environmental and firm specific variables and they play an important role in BOD effectiveness (Murphy and McIntyre, 2007, p.211). There are three important elements in corporate board structure namely the CEOs, who are the inside directors and are in most cases top managers of the firm, and outside directors, and all have the knowhow of what a good and a bad project is (Kyereboah-Coleman and Biekpe, 2007, p.69). Generally it can be said that directors of the company may be classified in two types: executive- the ones who are delegated some executive powers and are supposed to run the company. They elect to board because they are a source of information about the firm's day to day operations. And the non executive boards are boards that have some contractual relationship with the firm and they provide independent counsel to the firm. They may also hold top level managerial position in other companies (Kostyuk, Braendle, and Apreada, 2007, p.141; Hitt et al., 2009, p.285).

### *2.5.1 Role of the Board*

Corporate governance in general and the role and functions of boards of directors in particular have emerged as critical topics for organizations and the society as a whole in which they exist (Burke, 2003, p.346). The board of directors of a company has the responsibility of acting in the interest of that company in which they are assigned. And are supposed to protect shareholders' interests, have a fiduciary duty to perform activities in order to ensure the firm's profitability and share value. The board is considered as the most important internal monitor because it is one part of the firm's organizational structure at the top of the corporate hierarchy (Kim and Nofsinger, 2007, p.41-42).

In General, the responsibility of the board is to offer vision and direction for any corporate entity, to hire, evaluate, and perhaps even to fire top management, to vote on major operating proposals and on major financial decisions, to offer expert advice to management and to make sure whether the shareholders received accurate reports of both firms activity and financial conditions IBID.

### *2.5.2 Board Composition*

Board of director literature tells us, board composition can impact organizational performance. In this paper, four conceptual board composition drivers are developed to explain the factors' impacting on firm's performance. Namely board size, board independence, and board member gender and board competency.

### *2.5.3 Board Size*

Determinants of corporate boards' sizes become significant especially when corporate boards have been the focus of attention for some time now. And is considered as tip to the head of the governance structure of any corporate entity (Kyereboah-Coleman and Biekpe, 2007, p.69).

Much evidence supporting both points of view-small and large sided board was collected during review of our literature. It is ambiguous to define what small or large board is. According to Carter and Lorsch (2004, p.89-90), the average number of board is around thirteen in Europe. These averages conceal huge variations among companies and across countries, since one size does not fit all. Kim and Nofsinger (2007, p.47), have made research and argued that large corporate boards may be less efficient due to the difficulties in solving agency problem among members of the board. Large board creates less value than small boards. When boards become too big, director free riding increase within the board and the board becomes more symbolic and less a

part of the management process. That means for a board with few directors, each board member may feel to add more effort, as they each become conscious that there are only a few others monitoring the firm. On the other hand each member of larger boards may simply assume that the many other members are monitoring. Additionally with regard to large boards, it is difficult to reach common understanding and thus is hard to get anything meaningfully done. Therefore, smaller board can be seen as more flexible and more active. But it should not be eliminated that having a large board size is a benefit to corporate performance as a result of enhancing the ability of the firm to establish external links with the environment, securing more rare resources and bringing more exceptional qualified counsel (Dalton and Daily, 1999, p.674.). Evidence from Belkhir (2009, p.203) also shows idea which is in favor of large board. The study was investigated to analyze the relationship between board size and performance in a sample of 174 companies in US. Their finding was in favor of a positive relationship between board size and performance. The higher the number of directors sitting on the board the more performance is.

From an agency perspective, it can be argued that a larger board is more likely to be watchful for agency problems because a greater number of qualified people will add their expertise in reviewing management actions (Kiel and Nicholson, 2003, p.193-194).

Mallin, (2004, p.132) recommended that the board size to consist of no more than six directors. But, boards can be larger than this though it would not be the general case.

In addition, Pfeffer (1972, p.223) argued the requirement for a large board certainly increases as the size of the organization increases. This occurs due to the following reasons; first, large organizations are typically more diversified, and consequently have a need to deal with relatively more sectors of the environment. Second, large organizations have a greater impact on society and the economy because of their size, and therefore there is again a greater need to have more members who can relate and legitimate the organization to its external environment.

#### *2.5.4 Board Independence*

There is a general consensus that when a board has a higher fraction of non-insider referred as outside or independent director (Kim and Nofsinger, 2007, p.46). Mallin (2006, p.235) defined independent directors as directors who apart from receiving a director's remuneration do not have any other material pecuniary relationship or transactions with the company, its promoters, its management or its subsidiaries, in which the judgment of the board may affect their independence of judgment. Whereas inside director is individual on the board of directors who is an employee of the company (Siegel and Shim, 2006, p.505). Independence is not only a function of the proportion of inside to outside directors, rather it includes whether the board has dual leadership role and the degree of director share ownership. Like boards with heavy share ownership, boards with dual leadership are considered less independent (Murphy and McIntyre, 2007, p.213). Starting the 90s the concept of board independency became popular and globally many countries started to follow the guide line that stipulates the minimum level for the representation of outside director on boards of publicly traded companies. As a result, in most countries, these minimum standards represented a dramatic increase in outside director representation. The movement towards more outside directors is believed that, boards with more outside directors will lead to better board decisions and better corporate performance. This belief rests in large on faith rather than evidence (Dahya and McConnell 2005, p.1). OECD broadly stated that, there should be an adequate number of independent non executive directors and it is also defined what an independent board mean. For example, "they should not be engaged in business relationships with the company or its subsidiaries, or with the executive directors or shareholders or group of shareholders who control the company in such a way as would influence their own judgment. They should not be immediate family members of the executive directors of the company. In terms of owning shares, they may win shares but not such a quantity that would enable them to have control over the company or to exercise significant influence." Independent directors' presence is recognized as representing the



interest of all shareholders including the minority (Mallin, 2007, p.133). "From a stewardship theory perspective, it is the ratio of inside to outside directors that is of relevance, since inside directors can bring superior information to the board on decisions (Kiel and Nicholson, 2003, p.193-194)".

According to Bhagat and Black (1998, p.1) and Hirschey, John and Makhija (2009, p.225), board of directors of American public companies and EU with majority of independent directors behaves differently, in many ways, than boards without such a majority. Some of these differences appear to increase firm value while others may decrease firm value. There is no convincing evidence that shows the presence of majority of independent directors correlates with greater firm profitability or faster growth in large public companies. Particularly, no empirical evidence for current proposals supports for firms to have majority independent boards with only one or two inside directors. In contrast, some evidence also shows that firms with majority-independent boards are less profitable than other firms. Therefore, it can be recommended for firms to have a moderate number of inside directors.

### *2.5.5 Board Member Gender*

In many countries, the question concerning getting more women on boards and in top executive jobs become a highly debated issue. For example, in Norway's case, the political initiatives are regulating the proportion of women among board members. The results to Danish firms also showed to some extent supporting the view that a more gender diversity in top management positions would improve the financial performance (Smith, Smith and Verner, 2006, p.588).

It is argued that women directors on corporate boards offer many contributions. Corporations can gain competitive advantage by being receptive to women's contribution at the top (Huse and Solb, 2006, p.113). For example having women on boards impacts the reputation of a company, provides strategic input on women's product/market issues and company direction, improves the constructiveness of board processes and deliberations, and contributes to the firms' female employees (Burke, 2003, p.347).

There are reasons which are supported by a demographic case in favor of women corporate directors. First current male directors are aging and many are soon to be retiring. Second, as board membership requirements and greater understanding of the working of any particular firm increase, male board members will hold fewer directorship. In addition, fewer qualified males will be available when demands for knowledge and skill are raised. Critical requirement for some board members in the past which opened up more opportunities for women (Burke, 2003, p.347).

Firms which are engaged in customer oriented business, have more women directors who are being seen as employers of choice. Having more women on board is seeing as sign of good governance and an indicator of good management, more importantly the reputation of an organization may be heightened (Vinnicombe, Singh, Burke, Bilimoria, and Huse, 2008, p.3).

Firms with a higher ratio of women directors may have different impacts on the performance of particular board operational and strategic control task. Board operational control tasks can be defined as the board's responsibility to supervise managerial decisions regarding investments, cash flow, dividends, and financial statements. And this decision which is concerning with the firm financial and accounting situation is requiring strong quantitative background knowledge and skills. Whereas strategic control task, on the other hand, refers to monitoring managerial decisions with regard to the firm's strategy as well as organizational practices and policies such as safety, health, and environment, and hence assumes more analytical and visionary skills. In addition operational control tasks are more routine and ex post, where as strategic control tasks are ex ante, more complex and creative, and it requires a broader range of perspectives. This ability and women's attention to and consideration of the needs of others leads to women's active involvement in issues regarding strategic nature that concern the firm and its stakeholders. Since, women are particularly sensitive to exercise influence on decisions related to certain organizational practices: such as corporate social responsibility and environmental politics, they may contribute substantial help to

the board control tasks for issues of strategic nature. Therefore it is expected that boards with a higher ratio of women directors may be more effective in performing strategic control tasks (Nielsen and Huse, 2010 p.138).

#### *2.5.6 Board Competency*

Reviewing a number of the literatures shows definitions that, when synthesized and simplified, describe competency as a complex set of behaviors built on the components of knowledge, skills, and attitudes and the ability to apply them effectively (Carraccio, Englander, Wolfsthal, Martin, and Ferentz, 2004, p.252). According to Ollendick and Prinz (1993, p.111) age uses as a proxy for competence. People of certain age are presumptively competent and their competence may be challenged for cause. It is believed that knowledge, skills and experience gained through age.

A profile of the types of skills and experience needed on the board is created as a first step for nominating a committee. This list depends on the business in which the company engages and the strategy it expects to employ. Furthermore, it includes necessary functional expertise such as accounting, finance, marketing, operations management, industry expertise, and demographic diversity, along with general business experience applicable to the activities of the firm (Colley, Doyle, Logan, and Stettinius, 2003, p.64).

According to Financial Planners Standards Council (FPSC), Competency description for the Board is divided in to: 1) Personal/Interpersonal Competencies-those competencies that are expected to be intrinsic or fundamental to the candidate for Board service. It is used in the screening and selection process. 2) Governance Competencies- here board members are together responsible for governance and it is a specific skill set that is required of all Board members. And 3) Specific Competencies-This is expressed as technical skills and strategic competencies. Technical skills assist the organization with specific and ongoing aspects of organizational policy or governance business and individuals with these competencies assist the board in the oversight role. Whereas strategic competencies help the board to move forward in its strategic direction. Individuals with these competencies bring in connections with key target audiences knowledge of strategically relevant trends and issues, and expertise to assist positioning and operational planning (Certified Financial Planners' website).

#### *2.6 Accounting Profitability Measurements*

Profitability as a financial goal of every firm is used to expand the firm, and or to provide a cushion for future slow periods. Profitability helps a firm to ensure, its solvency, for owners to invest in the future. A firm can go out of business, if it incurs loses and become insolvent (Rogers, 1996, pp 1899). Profit is generally created only when a company operates effectively. Management's operating effectiveness is proven if the company can prosper, obtain funding, and reward the suppliers of its funds (Friedlob and Plewa, 1996, p.6-8).

Inter firm comparisons of profitability are comparisons of accounting profit among firms, and indicate the extent that different accounting methods are employed by firms or industries. Such comparisons are of questionable legitimacy and accuracy, since the accounting profitability of an industry is most unlikely that identical accounting policies can apply equally throughout all firms. In measuring accounting profit and making inter firm comparisons, it is important to view carefully the aggregated figures for an industry's profitability and necessary to be reasonably sure of the accounting conversation or policy and bases adopted (Franklin and Woodhead, 1980, p.273). Financial performance, measures of profitability and market value, and others, are considered as indicators of how well the firm satisfies its owners and shareholders. The ultimate goal for most firms is to increase their financial performance, particularly for public firms in shareholder value (Blocher et al., 2008, p.13&41). And the aim of performance measurement systems is to provide operational control and to provide external financial reporting (Kuwaiti, 2004, p.55).



Having the problem associated with operationalizing value maximization, it is surprising that companies tend to continue with familiar approaches to performance measurement that rely upon accepted accounting principles. While opponents of traditional financial measures deny the use of accounting based measures of performance, in practice the differences between cash flow, economic profit, and accounting profit indicators of performance evaluation are narrowed. (Grant, 2005, p.51). Generally financial statement of a firm contains the information needed to make decisions regarding a business. Many business' owners use their financial statements as requirements for creditors, bankers, or tax preparers only, but they are much more than that as such financial statement can give key information needed on the financial condition and the operation of a business (Pinson, 2008, p 113). The three following indicators of accounting profitability of a firm are used. Return on Equity, Profit Margin and Return on Capital Employed.

## *2.7 Measures*

### *2.7.1 ROE*

Return on equity (ROE) is a percentage determined by dividing profit to equity i.e. pretax profits from the profit and loss statement and equity or net worth from statement of financial position. The result represents the return you have made on the dollars that you invested in your business. Over several years, if your return on equity is lower than a certain minimum industry requirement over several years, you may consider selling your business and investigating the proceeds in bonds. As a consequence your return would be similar, your risk and the work much less (Tyson and Schell, 2008, p.240).

ROE ratio tells us how much profit a business earned in comparison to the book value of its shareholder's equity. It is useful especially for privately owned business, which is hard to determine the market value of owners' equity. Public corporations also use ROE just like book value per share, it generally plays a secondary role and is not the dominant factor driving market prices (Tracy, 2008, p.286).

Return on equity is the most appropriate profitability and potential growth indicators and it is the return obtained by the owners of the firm in exchange for providing equity. A business that has a high return on equity is more likely to be one that is capable of generating cash internally. For the most part, when return on equity of the company is higher as compared to its industry, the better the company is doing (Holz, 2003, p 35-36).

### *2.7.2 Profit Margin*

Profit margin is the most commonly and popular system used to measure corporate operations and judging a company's performance. It is computed by dividing the amount of net profit by gross sales. The profit margin is not fully understood by people invested in the market, though; it is often used for comparative purpose between companies and historical analysis. As a consequence, profit margin is expected unrealistically by market analysts and investors. Additionally, the acceptable level of profit varies among industries. For example, one industry may experience lower or higher average profit margin than another and this makes it impractical to arrive at a specific accounting standard for measuring profitability. Comparisons should be restricted to those among corporations in the same business line (Thomsett, 2009, p.210).

### *2.7.3 Return on Investment*

ROI is a traditional performance management tool. DuPont Power Company developed it in the early 1900s to help manage the vertically integrated enterprise. It is used to evaluate the performance of the company or its department by comparing its accounting measure of income to

its accounting measure of investment. The formula to measure ROI is:  $ROI = \text{Income} / \text{Investment}$ . Since long time ROI has been a valuable measurement tool and was the emerging tool to place a value on the payoff from capital investments. Currently, the application of the concept is being expanding to all types of investments (Phillips and Phillips, 2009, p.13).

ROI method is simple, helps to understand how you can influence company results by influencing the input of ROI, makes possible to compare performance of different companies or divisions since it controls for size differences across business units, changes in company's key ratios in time can be easily monitoring, can be easily used for evaluation of management performance (Ignatiuk, 2008, p.6-7). ROI is quantitative measure of investment and results and so it provides a company's management with a simple tool for examining performance i.e., it is a tool used to evaluate how well or poorly management performs. ROI helps management to reduce the factors of intuition and judgment to an interpretable mathematical calculation and compare alternative uses of invested capital. In addition, Creditors, potential investors and owners can compare the ROI of different companies and to industry benchmarks or norms and it provides information about a company's financial health., ROI is the most commonly used management indicator of company profit and performance and minimizes dissimilar activities of different sizes, and allows them to be compared (Friedlob and Plewa, 1996, p.6-8).

### 3. Conclusion

Board is the major component of corporate governance like chief executive officer (CEO), shareholders, stakeholders or community in general. This board is authorized to decide on the operations, management, and strategy of the company on behalf of the shareholders. Since, they represent their interests. In other words, it has influence on the future viability and continuity of the company. In addition, it is the guardian of shareholder welfare, as well as charged with the responsibility of ensuring that top managers are behaving in a way that will optimize firm performance for shareholders (Liu and Fong, 2008, p.2). National and international regulators argue that the corporate scandals are the results of poor board management and its corporate practices which lead to declining firm's performance. The existence of good corporate governance practices helps to prevent corporate scandals, fraud, and potential civil and criminal liability of the organization. It is also used to make good business. The image of good corporate governance enhances the reputation of the organization and makes it more attractive to customers, investors, suppliers (Lipman, and Lipman, 2006, p.3). Aguilera and Cazorra (2009, p.377) mentioned some universal principles of codes of good governance for effective corporate governance that are common to most countries. They are: a balance of executive and non-executive directors, such as independent non-executive directors; a clear division of responsibilities between the chairman and the chief executive officer; the need for timely and quality information provided to the board; formal and transparent procedures for the appointment of new directors; balanced and understandable financial reporting; and maintenance of a sound system of internal control.

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